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SUBJECT: CYPRUS' SUCCESSFUL TRANSITION TO EURO

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(U) This cable is sensitive but unclassified. Please treat accordingly.

11. (SBU) SUMMARY. By all accounts, Cyprus has managed the transition to the Euro quite successfully. The smooth changeover is being used by the incumbent government in the current presidential election campaign as an example of its sound economic governance. The only problem, covered extensively in the press, has been instances of unjustifiable price increases. Still, supported by an economy enjoying 4 percent growth, Cypriots seem increasingly positive about the Euro. END SUMMARY.

Cyprus Joins Eurozone

12. (U) On January 1, 2008, Cyprus, along with Malta, joined the Eurozone, the group of 13 other EU countries using the Euro as their national currency. The two new members have added a combined total of just 1.2 million people to the 320 million Europeans already using the Euro. Despite their small size, the two countries have equal voting rights with the other Eurozone members at the European Central Bank. Cyprus Central Bank Governor, Athansios Orphanides (a 19-year veteran of the U.S. Federal Reserve Bank), told us that he greatly looks forward to full participation at the ECB Board meetings.

13. (U) Cypriots are proud of their achievement in joining the Eurozone less than four years after their accession to the EU (on May 1, 2004.) For a small, open economy like Cyprus, the anticipated benefits include lower and more stable interest rates, greater fiscal discipline, reduced corporate expenses from currency conversion, increased potential to attract foreign investment, and an expanded horizon for Cypriot firms abroad. The head of the Cyprus Stock Exchange told us that even with the current volatility at his bourse arising from international financial turbulence, the situation would probably be worse if the Euro were not there to act as a monetary anchor for both domestic and foreign investors

14. (SBU) On the other hand, there are also challenges for Cyprus. Central Bank Governor Orphanides said on January 18, "Being in the Euro area means that monetary policy in our country is identical to that of all other countries with the common currency. Giving up monetary policy at the national level elevates the importance of

sound fiscal policy to maintain economic stability. It also places a premium on structural reforms, aiming to increase productivity and improve our international competitiveness and, hence, our standard of living. For these reasons, it is imperative to follow prudent policies and advance the necessary conditions to reap the potential benefits of the Euro." Comment: The Governor was clearly taking aim at the populist (and high-cost) programs being proposed by candidates in the current presidential race. End Comment.

British Bases Adopt Euro, North Makes Unofficial Transition

15. (U) As reported by the British Broadcasting Corporation (BBC), the Euro also became legal tender on British military bases in Cyprus, the first part of sovereign British territory to adopt the currency. Although the bases at Dhekelia, Episkopi and RAF Akrotiri are not officially part of the European Union, an estimated 10,000 Cypriots live or work there. Residents use the shops, cafes and beaches on the bases, so the authorities in the sovereign base areas decided to adopt the same rules as the Cypriot government. While the Turkish lira remains the official currency in the "TRNC," Euros are now very welcome and widely used in the north as well, just as Cyprus Pounds were before the transition.

Transition Logistics

16. (U) Even those in opposition to the government, including those who had opposed Euro accession at this time, agree that the transition itself has gone very smoothly. In a written statement shortly after January 1, 2008, Economic and Monetary Affairs Commissioner Joaquin Almunia noted that "the adoption of the Euro was proceeding very quickly, reflecting good preparation." ECB President Jean-Claude Trichet also stated on January 18, "Everything has gone smoothly. However, nothing would have been feasible without the exceptional performance of the Cypriot economy, during the convergence process."

17. (U) Already by January 5 (well before the expiration of the parallel circulation of the Cyprus Pound alongside the Euro on January 31), 72 percent of cash payments and 80 percent of all transaction were being conducted in Euro, while change in Euro was given in 97 percent of transactions. This success is ascribed both to Cypriots' familiarity with the Euro from travel to the Eurozone over the years and to the thorough preparations by the Central Bank and Ministry of Finance. These organizations designed and implemented a program that widely publicized the changeover, provided every household with a currency conversion calculator, and - via careful coordination with commercial banks - ensured that ATM machines, tellers and bank systems were fully prepared for January 11. It all went off smoothly with the only hitch being long lines of people seeking to convert their Cyprus Pounds to Euros the first week in January even though the old currency remained acceptable for transactions through the month and convertible for the rest of the year.

18. (U) Two weeks after the introduction of the Euro, a research study conducted by the European University Cyprus from January 16 to 24 revealed that perceptions domestically had changed in favor of the Euro: 55 percent of those interviewed responded that they expected the Euro to affect the Cypriot economy positively, up considerably from 32 percent several months earlier. Another 57 percent also said they expected the Euro to benefit them personally, compared to 29 percent several months earlier.

19. (U) The same study, though, revealed that 65 percent of interviewees said they experienced some form of rounding up of prices, although (perhaps incongruously), 96 percent of these paid the extra charges without complaining. Most of the price increases occurred, according to the study, at supermarkets, followed by kiosks, bakeries, barbers and hairdressers, parking lots, and medical services.

110. (U) The massive operation of physically importing and distributing Euros 8 billion in cash and, at the same, withdrawing CP 6 billion was completed in one month (by the end of January) with no currency lost or stolen. The Chief of Police was proud to accept credit for this achievement (since all cash deliveries were

conducted under armed police escort), and noted that elsewhere in the Eurozone there had been incidents robberies, thefts or burglaries, during the transition to the Euro.

Close Watch on Prices

¶11. (U) The GOC made every effort to ensure that the transition would not result in unjustified price increases. Months before the transition, the GOC had launched a voluntary "fair pricing" scheme, encouraging businesses to refrain from rounding up of prices. The GOC has also helped set up regional "Euro-Observatories," located in each of the four main districts, to monitor the changeover process. Specifically, these observatories have been tasked with implementing legal aspects of the changeover, providing information to the public, and acting as intermediaries between the government and the public. At the same time, they have been authorized to conduct investigations following infringements of the fair pricing scheme. While increasing prices was not illegal, the GOC used a "name and shame" approach to limit both the incidence and the magnitude of any increases. Another tool, which has proved effective, has been the obligation of traders and service providers to display prices in both Euros and Cyprus pounds from September 1, 2007 to September 30, 2008.

¶12. (U) Despite these measures, there have been many documented instances of price increases made under cover of currency conversion; an issue covered extensively by the media (print, in particular). There are also indications that some local businesses may have rounded up their prices early (i.e., sometime in the second half of 2007) in anticipation of the transition although this seems to have been the case more with small shops while big supermarkets made much of their promise to round prices down. Nevertheless, the end results may have contributed to the increase in Cyprus' Harmonized Index of Consumer Prices (HICP) to 3.7 percent by the end of December 2007, compared to the Eurozone's average of 3.1 percent.

¶13. (SBU) Comment. Learning from other countries' changeover errors and planning early and thoroughly, Cyprus' Euro transition has been completed without any major problems. With Presidential elections just around the corner (February 17 and 24), a smooth transition to the Euro was, clearly, a top priority for the incumbent government and President Papadopoulos is hoping that this success will serve as another feather in his regime's economic cap. Against a backdrop of strong growth, relatively low inflation and unemployment, diminishing public debt, and fiscal surpluses for the first time in three decades even in the face of global financial turbulence, it is easy for this government to claim successful stewardship of the economy, even if there are important structural challenges that have yet to be met. End Comment

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